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IN THE

Supreme Court of the United States

October Term, 1959.

No. 449.

LOUIS GAUDIOSI, CHARLES SCHWARTZ, and RANDOLPH PHILLIPS, individually and on behalf of all other stockholders of the Pennsylvania Railroad Company similarly situated,

RICHARD K. MELLON, ROBERT T. McCRACKEN, C. JARED INGERSOLL, WALTER S. FRANKLIN, JAMES E. GOWEN, PHILIP R. CLARKE, JAMES M. SYMES, JOHN A. DIEMAND, JOHN B. HOLLISTER, LAMMOT du P. COPELAND, DONALD DANFORTH, R. GEORGE RINCLIFFE, WILLIAM L. DAY, OTTO N. FRENZEL, FRED CARPI, DAVID C. BEVAN, JAMES P. NEWELL, Directors; BAYARD H. ROBERTS

and

THE PENNSYLVANIA RAILROAD COMPANY, a corporation, incorporated under the laws of the Commonwealth of Pennsylvania,

Respondents.

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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GAUDIOSI, ET AL.

v.

MELLON, ET AL.

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI.

OPINIONS BELOW.

Since the filing of the petition, the opinion of the Court of Appeals has been reported at 269 F. 2d 873.

QUESTIONS PRESENTED FOR REVIEW.

1. Whether the Court of Appeals did not properly apply the "unclean hands" doctrine to bar the grant of any relief in equitable actions brought, by both a candidate for a corporate directorship and others, to aid the candidate in his campaign for election, where the candidate, in furtherance of his campaign, had sent false and misleading communications to shareholders, which were intended to intimidate them, which caused them to withhold proxies solicited by management, and which were also a deliberate and malicious violation of the regulations of the Securities and Exchange Commission.

2. Whether a diversity action brought against a corporation and its directors in a federal district court in Pennsylvania by shareholders who own in the aggregate less than 0.0002 of the outstanding shares of the corporation may not properly be dismissed upon the failure of

the plaintiffs to enter the security for expenses ordered by the court pursuant to § 2 of the Pennsylvania Act of April 18, 1945, P. L. 253, 12 P. S. § 1322, which authorizes security to be required in such an action of plaintiffs who hold less than 5% of the outstanding shares of the corporation.

STATEMENT OF THE CASE.

Petitioners brought two civil actions in the District Court for the Eastern District of Pennsylvania in support of the candidacy of petitioner Phillips for election as a director of the Pennsylvania Railroad Company (hereinafter called the "Company") at its 1958 annual election. The Company opposed Phillips' candidacy on the ground that his election would be inimical to the best interests of the Company and its shareholders and set forth its views in letters which were "cleared" by the Securities and Exchange Commission before they were sent to the shareholders.

The first suit complained that the Company sent to its shareholders proxies in the customary form instead of in the form of a ballot;[1] that the language used to inform shareholders of their right to cumulate their votes did not include a quotation of the full text of the provision of the Pennsylvania Constitution creating such right; that some of the Company's proxy material was false and misleading; and that the Company used corporate funds for proxy solicitation expenses. The substance of the relief sought was an injunction against the solicitation and use of the Company's proxies and the use of Company funds for such solicitation, and a mandatory order that the Company supply all shareholders with a ballot form of proxy and distribute to shareholders at Company expense a statement by Phillips to refute what he alleged was false and misleading. After hearings, the District Court held petitioners' complaints to be without merit and filed findings of fact

1. The proxies used by petitioners were in the same form as those used by management.

and conclusions of law on the basis of which the complaint was dismissed.

The second suit, which was begun three days after the dismissal of the first, complained that the Company had declined to deliver to petitioner Phillips lists of selected shareholders of the Company specially prepared by it for its own use; that the Company had declined to deliver to petitioner Phillips a set of proxy forms which had been addressed to certain shareholders at his request and were being held by the Company for mailing pursuant to the proxy rules of the S. E. C.; that the Company's proxy material omitted certain specified facts; that the Company used its own name and letterhead and some of its officers and employees to solicit proxies; and that some of the Company's proxy material was false and misleading. It sought an order requiring the individual defendants to pay the expenses of petitioners' proxy solicitation, an injunction against the use of corporate funds by the Company for proxy solicitation, a voiding of all proxies received by the Company and a decree, based on an ostensible derivative claim brought on behalf of all the shareholders, requiring the individual defendants to pay to the Company all costs incurred by it in giving notice to shareholders of the annual meeting as well as in soliciting proxies.

After the complaint was filed petitioners attempted to amend it by naming two Swiss banks as new defendants and sought to enjoin them from voting the stock of the Company registered in their names. This claim was dismissed by agreement of petitioners and counsel for the Swiss banks after it appeared that petitioners, by means of the telegram hereafter referred to, had accomplished their purpose of keeping the Swiss banks from voting all the stock registered in their names.[2]

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2. Petitioners' assertion at pages 4 and 28 of their petition that this count was dismissed by "agreement of the District Court and all parties" is not true, since the agreement to dismiss that count was made by petitioners and counsel for the Swiss banks. (Transcript,

After hearings, the District Court held that the derivative claim had been inadequately presented by the petitioners and ordered a rehearing. The court held all other complaints of the petitioners to be without merit and made findings of fact and conclusions of law which denied relief not only on the merits but also on the ground that petitioner Phillips had been guilty of "unclean hands." The basis of the "unclean hands" finding was a telegram sent by petitioner Phillips to two Swiss banks, which together were the registered owners of approximately 800,000 shares of the Company's stock. The text of the telegram appears at pages 18-19 of the petition and at pages 13a-14a of the appendix thereto. The District Court found that the telegram contained false and misleading statements and omitted material facts, that it had been sent by petitioner Phillips to the banks deliberately and maliciously with an intent to intimidate the banks and to cause them to withhold proxies for management, and that by the sending of the telegram and the failure to file it with the S. E. C. petitioner Phillips had knowingly, maliciously and intentionally violated the proxy rules of the S. E. C.

As a direct result of the receipt of the telegram the banks voted only approximately 100,000 of the 800,000 shares which they held (Appendix to Petition, 14a-15a). These were voted for the management's candidates, as all the shares held by the banks had been customarily voted theretofore.

Subsequently the derivative claim seeking an injunction was also dismissed because of the petitioners' failure to comply with an order of the court, pursuant to a Pennsylvania statute,[3] requiring petitioners to enter security for expenses, including counsel fees, in the amount of $3,000.

Civil Action No. 24,654, pp. 254-5.) Respondents had no occasion to agree or disagree to the dismissal of the claim against the banks, since it did not affect the "unclean hands" issue raised by respondents on the basis of petitioner Phillips' conduct with respect to those banks.

3. Act of April 18, 1945, P. L. 253, 12 P. S. §§ 1321-3.

In affirming the order of the District Court with respect to the dismissal of the derivative claim in the second action the Court of Appeals held that the order requiring the security was a valid exercise of the court's discretion and that the petitioners had not complied with it. With respect to all other claims of petitioners in both actions the Court of Appeals held that the findings of fact of the District Court with respect to petitioner Phillips' "unclean hands" were amply sustained by the record and that his "unclean hands" barred any relief in either action, since both actions were instituted to further petitioner Phillips' candidacy for director.

During the progress of the second action in the District Court the election of directors of the Company was held. At the election approximately 10,000,000 shares were voted. Of these petitioner Phillips received the vote of about 1,000,000 shares. Petitioner Phillips failed of election since, even on a cumulative voting basis, he received only 5,997,982 votes while the management candidate with the lowest number of votes received 9,004,766 votes.

ARGUMENT.

Summary of Argument.

The petition for a writ of certiorari should be denied for the following reasons:

1. The fundamental question raised in the petition involves merely a determination of fact—whether petitioner Phillips' misconduct in the course of his campaign for election as a director of the Company was such as would justify denying the relief of a court of equity under the doctrine of "unclean hands."

2. The purported constitutional question involving the state statute has already been decided by this Court, and in any event petitioners have no standing to raise it.

I. The "Unclean Hands" Finding.

The decision of the Court of Appeals presents no question which is a proper subject of review in this Court. The matter involves only the personal interest of petitioner Phillips and the two other petitioners, who have associated themselves with him in this litigation solely for the purpose of advancing his personal interest in his unsuccessful candidacy.[4] The decision will affect no other litigants and is of no general public importance. The only

4. Petitioners Gaudiosi and Schwartz appear to be merely nominal parties added to give the suit an appearance of being more than the mere personal venture of petitioner Phillips. The record in this case shows that Gaudiosi and Schwartz have no interest in its outcome apart from their expressed desire to have Phillips elected a director (Civil Action No. 24,654, Plaintiffs' Exhibit 11 and Complaint, ¶ 30). They have been used in like manner before. See *Gaudiosi, et al. v. Clement, et al.*, Civil Action No. 19,072, U. S. D. C., E. D. Pa. (1957), unreported.

legal proposition involved is the application to a specific set of facts of a generally recognized principle which has been consistently applied in courts of equity for generations. The decision of the Court of Appeals, turning as it does on the particular facts of this case, presents no possible conflict with the decisions of this Court or of any other court. There is also no occasion for the exercise of this Court's power of supervision since the record amply supports the actions of the courts below. Those actions involved determinations of fact and were well within the accepted and usual course of judicial proceedings, as appears in the recital of the proceedings in the opinion of the Court of Appeals. In these circumstances review by this Court on certiorari is not called for since the case depends essentially on its own specific facts.

There is no doubt of this Court's recognition of and adherence to the general principle that the "unclean hands" of a plaintiff in an equity suit will bar relief. The effort of petitioners to escape the application of this principle is insupportable. In *Keystone Driller Co. v. General Excavator Co.*, 290 U. S. 240, 245-246 (1933), this Court said that courts of equity in applying this principle "are not bound by formula or restrained by any limitation that tends to trammel the free and just exercise of discretion." Hence there is no basis for the suggestion at page 21 of the petition that "unclean hands" may be found only in "acts of criminality or actual fraud or corruption." No such rigid formula limits this doctrine of equity as the forum of conscience. That was made clear by this Court in *Precision Instrument Mfg. Co. v. Automotive Maintenance Co.*, 324 U. S. 806, 815 (1945), which ruled that "Any willful act concerning the cause of action which rightfully can be said to transgress equitable standards of conduct is sufficient cause for the invocation of the maxim by the chancellor."

Within that broad framework of the doctrine of "unclean hands" the only question here is whether the courts

below properly exercised their discretion in applying the doctrine in this case. That is essentially a question of fact, which required only a determination of whether the conduct of petitioner Phillips was such that it could rightfully be said to transgress equitable standards of conduct. The District Court found as a fact that the telegram to the Swiss banks was false and misleading and was deliberately and maliciously sent with an intent to intimidate the banks and lead them not to vote their stock in favor of the candidates of the management. The Court of Appeals ruled that the record "amply sustains" these findings (Appendix to Petition, 12a, 15a).

These findings should be determinative here under the "two-court rule" as expressed in *Comstock v. Group of Investors*, 335 U. S. 211, 214 (1948):

> "A seasoned and wise rule of this Court makes concurrent findings of two courts below final here in the absence of very exceptional showing of error."[5]

There could be no "very exceptional showing of error" with respect to the findings here. The telegram to the Swiss banks was patently false and misleading. It threatened lawsuits and accused the banks of, among other things, arbitrary and undemocratic action, fraud, a violation of the antitrust laws of the United States, of the

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5. Both the long history of this rule and its applicability in an equity action is illustrated by *Towson v. Moore*, 173 U. S. 17, 24 (1899):

> "A series of decisions of this court has established the rule that successive and concurrent decisions of the two courts in the same case, upon a mere question of fact, are not to be reversed, unless clearly shown to be erroneous. This rule, more often invoked in admiralty cases, is yet equally applicable to appeals in equity."

See also *Houston Oil Co. of Texas v. Goodrich*, 245 U. S. 440, 441 (1918); *Southern Power Co. v. Public Service Co.*, 263 U. S. 508, 509 (1924); *Graver Mfg. Co. v. Linde Co.*, 336 U. S. 271, 275 (1949); *Corn Products Ref. Co. v. Commissioner*, 350 U. S. 46, 51 (1955).

regulations of the Securities and Exchange Commission and of the rules of the New York Stock Exchange, and implied that the individual respondents and the management of the Company were dictators and totalitarians. A sufficient illustration of the falsity of the accusations was Phillips' admission upon cross-examination that neither the S. E. C. regulations nor the New York Stock Exchange rules applied to the Swiss banks (Appellees' Appendix in Nos. 12,742-12,745, 51b, 56b-57b). The other charges are outrageous on their face.

Petitioner Phillips was cross-examined extensively in the District Court with respect to the telegram (Appellees' Appendix in Nos. 12,742-12,745, 33b-57b). That cross-examination, together with his appearances as a witness in both the suits below, gave the District Court abundant opportunity to determine his actual purpose and intent in sending the telegram. The District Court found as a fact that the telegram not only contained false and misleading statements but was deliberately and maliciously sent with an intent to intimidate the banks. That finding is the essence of this case and was ruled by the Court of Appeals to be amply supported by the record. Faced with such a finding of fact, petitioners can offer nothing of substance in support of their efforts to escape the application of the "unclean hands" doctrine.

The suggestion (Petition, p. 23) "that the statements in the telegram were entirely proper" shows a callous disregard of the facts, as disclosed by the rulings of the courts below or even by a mere reading of the telegram itself.

The argument (Petition, pp. 25-27) that the vice of the telegram does not fall within the "unclean hands" doctrine is refuted by the *Keystone Driller* and *Precision Instrument* cases cited above on page 7. The finding that the telegram was false and malicious and intended to intimidate makes it plain enough that it was "unconscionable" and sent with "corrupt intent", although it is clear that the cases do not require so limited a test to justify the application of the

doctrine. The condemnation by the courts below of the conduct of petitioner Phillips could not be more explicit. Petitioners' summary of what "the Court of Appeals' decision boils down to" (Petition, pp. 3, 26) exhibits a cynical disdain for the essential dishonesty of the telegram. It contained more than merely "challenged misrepresentations" and it was not in fact "withdrawn" by the second telegram which petitioner Phillips sent to the Swiss banks, since that continued the threat of unjustified litigation against the banks.

The argument (Petition, p. 28) that the telegram had no bearing on the "cause of action" in each of the two suits instituted by petitioners is absurd since the telegram was intended to have and had a direct bearing on the outcome of the election of the Company's directors, which was the only matter with which the two suits were ultimately concerned. The importance to petitioners of whether the stock of the Swiss banks would be voted at the election was revealed by the fact that they had sought to enjoin the voting of that stock by the filing of an amendment of the complaint in the second suit.

The claims, direct and implied (Petition, pp. 3, 4, 28), that petitioners had no notice that the "unclean hands" question would be raised is quite inaccurate since the ninth defense in the answer of certain respondents to the complaint in the second suit (Civil Action No. 24,654) specifically alleged that petitioners "were precluded from obtaining any equitable relief in this action by reason of their own conduct, and particularly by reason of the nature of the material they had caused to be prepared and distributed in the solicitation of proxies, in the solicitation of the revocation of the appointment of proxies who had announced their intention to vote for the candidates recommended by management, and otherwise in support of the candidacy of plaintiff Phillips." Evidence on the point was received (Appellees' Appendix in Nos. 12,742-12,745, 33b-34b, 36b, 59b) and peti-

tioners were given ample opportunity to meet this issue (*id.*, 37b).

The argument that the "unclean hands" doctrine may not be invoked "to bar legal rights and remedies" (Petition, pp. 5, 29-30, 31) is a mere play on words. It ignores the fact that the relief sought by petitioners in their complaints invoked the equitable powers of the District Court.[6] Throughout the litigation below petitioners repeatedly insisted that the District Court and the Court of Appeals exercise the powers of a court of equity—and this they have now done.

The argument (Petition, pp. 4, 32) that the "unclean hands" finding in the second suit could not be applied by the Court of Appeals to the first suit or could not be applied to the petitioners other than petitioner Phillips misconceives the nature of the doctrine, which is founded on the preservation of the integrity of the court itself. Both of the suits below, and the interest of all the petitioners, were directed solely toward the accomplishment of petitioner Phillips' desire to be elected a director of the Company. His unconscionable conduct necessarily precludes any relief to serve that end.[7]

The contention (Petition, pp. 19-20) that S. E. C. proxy rule X-14A-2(a) is a "defense" against the "unclean

6. The references to quo warranto (Petition, p. 30) are merely distracting since federal courts have no jurisdiction to entertain such a proceeding. *United States v. First Federal Savings & Loan Ass'n.*, 248 F. 2d 804 (7th Cir., 1957), *cert. denied* 355 U. S. 957 (1958).

7. Gaudiosi and Schwartz cannot be insulated from the effects of Phillips' misconduct. Contrary to the implication of the statement at the top of page 4 of the petition, they were associated with Phillips as "participants" in his campaign for election as a director, as defined in Regulation 14A of the Securities and Exchange Commission, 17 CFR § 240.14a-11, and can hardly pose as people with independent interests, seeking independent objectives. Phillips himself admitted that he was not alone in deciding the course of his strategy with respect to the telegram to the Swiss banks when he testified that he consulted his "associates" in deciding how that telegram should be handled with the Securities and Exchange Commission (Appellees' Appendix in Nos. 12,742-12,745, 42b). See also footnote 4 on p. 6.

hands" doctrine is absurd. The telegram to the Swiss banks was false and malicious and "unconscionable" whether or not it was subject to the S. E. C. rules. It is no "defense" to such palpable dishonesty that the telegram may or may not have also been within the prohibitions of administrative regulations of the S. E. C. The telegram did in fact violate the S. E. C. rules, as found by the courts below,[8] but even if it had not, its studied falsity and deliberately misleading character, shocking as it was to the courts below, would still constitute "unclean hands".

II. The Dismissal of the Derivative Claim.

Petitioners do not dispute here that the District Court and Court of Appeals correctly held that they had failed to comply with the order of the District Court with respect to the filing of security in the amount of $3,000 and that under the statute the derivative claim was properly dismissed for that reason. Petitioners apparently purport, however, to raise a constitutional question with respect to the validity of the Pennsylvania statute under which the order for the security was originally made.[9] Respondents submit that there is no such constitutional question of substance in this case and that even if there were petitioners would have no standing to raise it.

The Court of Appeals ruled that it had already decided the question of the constitutionality of the Pennsylvania statute in *Knapp v. Bankers Securities Corporation*, 230 F. 2d 717 (3d Cir., 1956), and *Murdock v. Follansbee Steel*

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8. It violated S. E. C. Rule X-14A-6 because it was not filed with the S. E. C. before it was sent to the banks. It violated S. E. C. Rule X-14A-9 because it was false and misleading both in what it said and in what it omitted to say.

9. We say "apparently" because the argument of the petition (p. 32) does no more than urge the postponement of federal decision of federal constitutionality, a claim advanced for the first time in the petition for rehearing in the Court of Appeals.

Corp., 213 F. 2d 570 (3d Cir., 1954).[10] Those cases in turn relied on the decision of this Court in *Cohen v. Beneficial Loan Corp.*, 337 U. S. 541 (1949), which held constitutional a similar statute of New Jersey. Thus, the question of constitutionality has already been determined here.

There is no merit in the contention of petitioners (Petition, pp. 6, 32) that the Pennsylvania statute is unconstitutional because it does not exempt the holders of shares of a market value of $50,000 from the requirement of security. The *Cohen* case ruled that it is constitutional for a state statute to require security in a derivative action where the plaintiffs do not own a specified percentage of the company's stock. It was held that the market value of the plaintiffs' stock could be used as an alternative test but not, as petitioners argue, that the statute must provide both of these alternatives.[11]

However, petitioners are not in a position to complain of the absence of a $50,000 test in the Pennsylvania statute

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10. The Court of Appeals did not explicitly rule on the contention of the respondents that it had no jurisdiction of the question. Petitioners attacked the constitutionality of the Pennsylvania statute at the time of the motion of respondents that security be required. The District Court implicitly overruled this objection of petitioners by its entry of an order on August 6, 1958 requiring the security. That order was an appealable order at the time it was entered. *Cohen v. Beneficial Loan Corp.*, 337 U. S. 541, 545-547 (1949). The time for appeal of that order expired on September 5, 1958, which was before the time petitioners took any appeal from any order in the second suit. Even if the appeal which was taken from the dismissal of the derivative claim for failure to comply with the order of August 6 had been timely to give the Court of Appeals jurisdiction of the question of constitutionality, the merits of the August 6 order still could not be considered in the Court of Appeals since that order was not specified in the notice of appeal as required by F. R. C. P. 73(b). Hence, any question of constitutionality of the Pennsylvania statute was not properly before the Court of Appeals for decision.

11. The Pennsylvania statute was in force at the time the *Cohen* case was decided and in a footnote at page 549 of that decision this Court referred to the Pennsylvania statute as one of the type that several states had enacted to deal with the problem of the misuse of the opportunity to bring "strike suits."

since the aggregate value of their stock was only $28,800 when the suit was commenced. Hence the $50,000 test would have no application to them. A party cannot challenge the constitutionality of a statute unless he can show that he is within the class whose constitutional rights are alleged to be infringed. See *Barrows v. Jackson*, 346 U. S. 249, 255-257 (1953).

III. Conclusion.

The petition presents no proper subject for review in this Court and should be dismissed.

Respectfully submitted.

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October, 1959.